10-24-88
New 3 H

L-2284

Texas Agricultural Extension Service

Tax Considerations on the Sale of Your Home

Susan Quiring*

Changes in family size, employment or other circumstances frequently make it desirable or necessary to sell a personal residence. If you have owned a home for several years, there probably has been a sizable increase in its value. Current tax laws could substantially reduce tax liability on the gain realized from the sale. Two provisions that pertain to the sale of a taxpayer's principal residence are purchasing a new residence and an exclusion option for older homeowners.

For home owners of any age

The first provision applies to home owners of any age. It requires taxpayers to defer taxes on a gain realized from the sale of a principal residence if a replacement residence that costs at least as much as the sale price of the original residence is purchased or built within 24 months of the sale. Normally, only one tax-deferred sale is allowed during each 24-month period; an exception in the act permits more than one such transaction (usually called *roll-over*) within 24 months if the taxpayer relocates for employment purposes. The same standards currently in effect concerning deductibility of moving expenses are used to determine if the sale was caused by a change of employment location.

For home owners 55 and older

The second provision pertains to taxpayers who are 55 or older at the time of the sale (only one spouse needs to be 55). Qualifying taxpayers can elect to exclude from gross taxable income up to $125,000 of any gain realized from the sale of a principal residence ($62,500 for married individuals filing separate returns). However, this election can be exercised only once in a lifetime and is binding on both spouses. Additionally, the taxpayer must have owned and occupied the property as a principal residence for three or more years during the five-year period before the sale.

Because the exclusion may be elected only once, this provision has important implications for married taxpayers who elect it during a marriage that may later be dissolved by divorce or by the death of a spouse. Remarriage will not reinstate the election.

The act permits taxpayers who are 55 or older to use both provisions to minimize taxes on the sale of their home. For example, suppose a 55 or older taxpayer realizes a $200,000 gain on a principal residence sold for $400,000. If that taxpayer purchases or builds a replacement for $275,000 within 24 months, taxes on the entire gain are minimized. This home owner could postpone $75,000 through

*Extension housing specialist, The Texas A&M University System.

Texas Agricultural Extension Service • Zerle L. Carpenter, Director • The Texas A&M University System • College Station, Texas

TABLE 1 Computation of Gain on the Sale and Adjusted Sales Price		
Line No.		**Amount**
1, 2	These lines ask for the dates of the sale and replacement. They are not included in the calculations.	
3	This line is used to determine the qualifications of the taxpayer to elect the over age 55 exclusion. It is not included in the computations.	
4	Selling price of the residence	$182,000
5	Commissions and other expenses of sale not deducted as moving expenses.	10,000
6	Amount realized (subtract line 5 from line 4).	172,000
7	Basis of residence sold.	30,000
8	Gain on sale (subtract line 7 from line 6). If zero or less, enter zero and do not complete the rest of form.	142,000
9, 10	Apply to over age 55 exclusion. See Table 3.	
11	Fixing-up expenses.	2,000
12	Adjusted sales price (subtract line 11 from line 6).	170,000

the roll-over provision and exclude $125,000 by the election available to older taxpayers. This permits those 55 or over to "step down" in the housing market and minimize their tax burden.

IRS Form 2119

The Internal Revenue Service has provided Form 2119, entitled "Sale or Exchange of Principal Residence," to help taxpayers calculate: (1) the gain on the sale of the old residence, (2) the adjusted sales price of the old residence, (3) the amount of taxable gain and (4) the adjusted basis of the replacement residence (if any).

Tables 1, 2 and 3 show the calculations related to a hypothetical sale of these residences and the replacement each owner purchased. When combined, these three tables are, for the most part, a duplication of IRS Form 2119 used by taxpayers who sold a residence in 1987.

Table 1 includes the calculation of the gains on the sale of the residences (which for our purposes all sold for the same price) and the adjusted sales price of the residences (lines 8 and 12 respectively).

Table 2 includes lines 13 through 16 of IRS Form 2119. This is the portion of the form for all taxpayers under 55 and those 55 or over *who do not elect* the $125,000 exclusion. It shows the amount of taxable gain on a sale and the adjusted basis of a replacement residence purchased or built within the 24-month time limit. To illustrate the effect of various priced replacements on taxable income, the three cases are included in Table 2 (IRS Form 2119 is used for the actual transaction and thus has only one column). Line 13 shows the assumed cost of the new residence to be $175,000 for the Smith's home, $75,000 for the Jones' home and $25,000 for the Thomas' home.

TABLE 2 Computation of Taxable Gain on the Sale: Adjusted Basis of New Residence Without $125,000 Exclusion				
Line No.		**Amount**		
		Smith	Jones	Thomas
13	Cost of new residence.	$ 175,000	$ 75,000	$ 25,000
14	Gain taxable this year. Subtract line 13 from line 12. If zero or less, enter zero. Do not enter more than line 8. (Line 10 does not apply in this situation).	-0-	95,000	142,000
15	Gain to be postponed. (Subtract line 14 from line 8.)	142,000	47,000	-0-
16	Adjusted basis of new residence. (Subtract line 15 from line 13.)	33,000	28,000	25,000

TABLE 3 Exclusion, Gain, and Adjusted Basis of New Residence				
Line No.		Amount		
		Smith	Jones	Thomas
9	For sales after July 20, 1981, enter the smaller of line 8 or $125,000) $62,500, if married filing separate returns).	$ 125,000	$ 125,000	$ 125,000
10	Part of gain included (subtract line 9 from line 8).	17,000	17,000	17,000
11	Fixing-up expenses.	2,000	2,000	2,000
12	Adjusted sales price (subtract line 11 from line 6).	170,000	170,000	170,000
13	Cost of new residence.	175,000	75,000	25,000
14	Gain taxable this year. (Subtract the sum of lines 9 and 13 from line 12. If zero or less, enter zero.) Do not enter more than line 10.	-0-	-0-	17,000
15	Gain to be postponed. (Subtract line 14 from line 10.)	17,000	17,000	-0-
16	Adjusted basis of new residence. (Subtract line 15 from line 13.)	158,000	58,000	25,000

Summary

Table 4 summarizes the effects of electing the $125,000 exclusion on taxpayers in the three assumed cases. Two important comparisons are included in the table: (1) the taxable incomes of the Jones and Thomas families are reduced substantially and (2) the adjusted basis (and consequent tax liability from a future sale) of the new residence for both the Smith and Jones families are affected.

The major points derived from Table 4 are:

1. Even if the $125,000 exclusion is not necessary to reduce the taxable income (the Smith's) of a seller who is 55 or older, it can increase the adjusted basis of a replacement residence. Because the exclusion is binding on both spouses this is a crucial point for a taxpayer who is considering the exclusion and may later marry someone who previously used the exclusion. If the decision is made to elect the exclusion, future tax relief will occur if the replacement residence is sold (because of the higher basis); if the exclusion is not used before the marriage it will not be allowed during a subsequent transaction.
2. The Jones case illustrates where the $125,000 exclusion reduces a $95,000 taxable gain to zero. The unused $30,000 of the exclusion increases the adjusted basis of a replacement principal residence that will reduce taxable gains, if forthcoming, from future transactions.
3. The Thomas case is more applicable for a retired taxpayer who decides to sharply "step down" in housing (from a $182,000 home to a $25,000 home). This case illustrates a substantial

TABLE 4 Summary				
		Smith	Jones	Thomas
I.	Disposition of gain without $125,000 exclusion.			
	a. Taxed (line 14).	$ -0-	$ 95,000	$ 142,000
	b. Postponed (line 15, changes the basis of new residence).	142,000	47,000	-0-
	Total gain (line 8).	$ 142,000	$ 142,000	$ 142,000
II.	Disposition of gain with $125,000 exclusion.			
	a. Taxed (line 14).	$ -0-	$ -0-	$ 17,000
	b. Excluded (line 9).	125,000	125,000	125,000
	c. Postponed (line 15 changes the basis of new residence).	17,000	17,000	-0-
	Total gain (line 8).	$ 142,000	$ 412,000	$ 142,000
III.	Adjusted basis of new residence.			
	a. Without exclusion (line 16).	$ 33,000	$ 28,000	$ 25,000
	b. With exclusion (line 16).	$ 158,000	$ 58,000	$ 25,000

decrease in current taxable income. It is consistent with tax policy that allows older taxpayers to use gains from the sale of their homes to meet their retirement needs.

4. A general observation from an examination of the examples is that taxpayers 55 or older who sell their principal residence and receive gains of $125,000 or more probably should take the exclusion (unless they think the exclusion amount will be raised in future legislation). All of the previous examples assume that the gain was in excess of $125,000. If the gain is less, line 9 of IRS Form 2119 allows only the actual gain to be excluded. If the entire $125,000 is not excluded in a transaction, the unused portion is forfeited forever. The taxpayer must decide whether to take whatever exclusion can be deducted or delay the election until some possible future transaction when the benefit may be larger.

Farmers, ranchers and some other taxpayers who use property partly as their home and partly for business have a slightly more complicated situation than illustrated above. If the whole property is sold, taxes can be postponed or excluded on only that part of the gain resulting from the sale of the home.

To make these computations, you must allocate selling price, basis, selling expenses and fixing-up expenses between the residence (including land and out-buildings associated with the home) and business property. Taxpayers involved in this kind of sale should seek professional assistance.

Note that for the Thomas family the amount identified as gain taxable this year (line 14) is limited to the total gain on the sale (line 8) rather than the $145,000 difference between the adjusted sales price of the old residence and the cost of the new residence.

Table 3 is the portion of the form that taxpayers who are 55 and older use to elect the $125,000 exclusion and to calculate their taxable gain. The same three cases from Table 2 are considered in Table 3, but the $125,000 exclusion is included in the computations to illustrate its impact.

Conclusion

Since the tax laws related to the provisions, definitions and limitations are complex and subject to continuous change, check IRS rules and regulations for changes that could take place in the future. This publication should not be used for making final tax decisions nor should it be viewed as a complete explanation. Expert tax advise is strongly recommended in all tax decisions and tax planning.

Acknowledgements

Appreciation to Don Stebbins, Extension real estate specialist, for the original version of this publication, and to Jack Friedman, Professor, Real Estate Research Center for reviewing the publication.

Reference

Internal Revenue Code, Section 1034

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Ecomonics. Acts of Congress of May 8, 1914, as amended, and June 30, 1914, in cooperation with the United States Department Of Agriculture. Zerle L. Carpenter, Director, Texas Agricultural Extension Service, The Texas A&M University System.
3M—9-88, New HHF